

# BUSINESS VALUATIONS

## WHAT'S IT WORTH?

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# Presentation Outline

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# History

- The valuation of closely held businesses first became a formal issue during the 1920's when the Eighteenth Amendment instituting prohibition was enacted.
- Businesses involved in the alcoholic beverage industry that were forced to close found it necessary to value their businesses to determine the extent of their losses.
- Since the 1920's, closely held businesses have been valued for a variety of reasons. Given the increasing number of people performing business valuation engagements, the AICPA has issued standards to improve the consistency and quality of practice among AICPA members. SSVS No. 1 is effective for engagements accepted on or after January 1, 2008.

# First Steps

- Before valuing a company, one must know the purpose and expected use of the valuation.
- Purpose will affect assumptions and methodologies, as there are many reasons to have a closely held business valued.
- Different valuation purposes call for different 'standards of value'.
- Different valuation purposes consider different regulatory requirements.

# Reasons for Valuation

- Mergers and acquisitions
- Sales and divestitures
- Buy / sell agreements
- Fairness opinions
- Shareholder transactions
- Capital infusions
- Estate planning and taxation
- Gift taxes
- Solvency opinions
- Insolvency opinions
- Divorce
- Employee Stock Ownership Plans (ESOPs)
- Employee benefit plans
- Expert testimony/litigation support
- Collateral valuations
- Purchase price allocations
- Charitable contributions
- Determination of net operating loss in bankruptcy
- Eminent domain proceedings

# Valuations as a Management Tool

There are a number of 'management planning' reasons to have a valuation done

- **Measure management's effectiveness**
  - Audits can measure operating effectiveness
  - Valuations can measure strategic effectiveness
- **Ownership transfers**
  - Value the business periodically to avoid a 'buy/sell showdown'
- **Estate planning**
  - Value the business to be aware of estate concerns
  - Value the business to support life insurance needs

# Compliance Concerns

More and more 'required' reasons for a valuation:

- **Taxes / Internal Revenue Service**
  - Estate and gift taxes
  - S-corporation elections
- **Financial Reporting (to name a few)**
  - ASC 350 – Intangibles – Goodwill and Others
  - ASC 718 – Compensation – Stock Compensation
  - ASC 805 – Business Combinations
  - ASC 815 – Derivatives and Hedging
  - ASC 820 – Fair Value Measurements
- **Compensation**
  - ESOPs
  - Share-based compensation – ASC 718 and IRC 409(A)
- **Litigation**
- **Regulation**
- **Different Standards of Value for Different Reasons!**

# Standards of Value

- Fair Market Value
- Investment Value
- Fair Value (financial reporting)
- Fair Value (litigation)

**Always work with your valuation expert to establish appropriate standard of value at the outset of the engagement!**

# Standards of Value – Fair Market Value

- **The IRS has defined Fair Market Value in Revenue Ruling 59-60:**

“The price at which the property would change hands between a willing buyer and a willing seller, when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts.”

- **The International Glossary of Business Valuation Terms has defined Fair Market Value as:**

“The price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arms length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.”

# Standards of Value – Investment Value

The *International Glossary of Business Valuation Terms* defines the **Investment Value Standard** as:

“The value to a particular investor based on individual requirements and expectations.”

## **Investment Value is:**

- Value to a specific buyer, usually synergistic or strategic.
- Typically commands higher value than Fair Market Value standard, because specific buyer is acquiring market share, products, processes, etc.
- Most common in mergers and acquisitions.

# Standards of Value – Fair Value

## ASC 820 defines Fair Value as:

“The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.”

# Standards of Value – Fair Value

## Fair Value Standard

- Commonly used in litigation.
- Definition based on state case law.
- Fair Value standard used when there is not a ‘willing seller’ and the court wishes to instill fairness by arriving at an ‘equitable’ value.
- Often computed as Fair Market Value without discounts for lack of control or marketability.

# Statement on Standards for Valuation Services (SSVS) No. 1

The Standards apply to ALL AICPA members providing services to value a business, an interest in a business, a security or an intangible asset

# Engagement Considerations

## The valuation analyst should consider:

- Subject entity and its industry
- Subject interest
- Valuation date
- Scope of the valuation engagement
  - Purpose of the valuation engagement
  - Assumptions and limiting conditions
  - Applicable standard of value
  - Type of report to be issued
- Applicable laws, regulations and standards
- Nature of the interest (controlling, minority, non-marketable, etc)

# Types of Valuation Reports

## For a valuation engagement with a conclusion of value:

- Detailed Report – structured to provide intended users the ability to understand the data, reasoning, and analyses underlying the valuation analyst's conclusion.
- Summary Report – intended to provide only an abridged version of the information that would be provided in a Detailed Report.

## For a calculation engagement with a calculated value:

- Calculation Report – a limited scope report based on agreed upon assumptions, conditions, and valuation approaches / methods

**The valuation analyst should indicate in the valuation report any restrictions on the use of the report (restrictions may be related to uses or users)**

# Valuation Considerations

## Most full scope valuations consider the following:

1. The nature of the business and the history of the enterprise from its inception.
2. The economic outlook in general and the condition and outlook of the specific industry in particular.
3. The book value of the stock and the financial condition of the business.
4. The earning capacity of the company.
5. The dividend-paying capacity.
6. Whether or not the enterprise has goodwill or other intangible value.
7. Sales of the stock and the size of the block of stock to be valued.
8. The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.

# Nature of the Business

The valuation analyst needs to consider both financial and non-financial information

**The information needed will depend on:**

- Nature of the subject interest
- Scope of the valuation engagement
- Valuation date
- Intended use of the valuation
- Applicable standard of value and premise of value
- Assumptions and limiting conditions
- Applicable regulations and other standards

# Nature of the Business

**Much of the data will come from the subject company / acquisition target:**

- Company background and 'demographic' information
- Key competitors, suppliers, customers
- Key management and personnel issues
- Financial statements and historical performance measures
- Forecasts and projected financial statements
- Prior sales of company stock / assets

**Company specific data will help identify risks and opportunities, and will influence specific company risks in the discount rate**

# Economic and Industry Data

## Why is it important? Where is it available?

- **Economic and industry data available from a variety of sources, including:**
  - Federal Reserve Board *Beige Books* ([www.federalreserve.gov/FOMC/BeigeBook](http://www.federalreserve.gov/FOMC/BeigeBook))
  - BV Library's *Economic Outlook Update* <sup>TM</sup> ([www.bvlibrary.com](http://www.bvlibrary.com))
  - Standard and Poor's Industry Surveys ([www2.standardandpoors.com](http://www2.standardandpoors.com))
  - First Research Industry Surveys ([www.firstresearch.com](http://www.firstresearch.com))
- **Financial benchmarking data:**
  - Integra Information ([www.integrainfo.com](http://www.integrainfo.com))
  - RMA Statement Studies ([www.statementstudies.org](http://www.statementstudies.org))
- **Cost of Capital Estimates:**
  - Ibbotson's / Morningstar's Stocks, Bonds, Bills, and Inflation Yearbook ([www.corporate.morningstar.com](http://www.corporate.morningstar.com))
  - Duff & Phelps, LLC Risk Premium Report ([www.bvmarketdata.com](http://www.bvmarketdata.com))

# Financial Condition of the Business

I see all the signs, but they're not very clear...

- In valuing a business or asset, an understanding of what the numbers mean is critical. Financial analysis tools and techniques can:
  - Isolate trends (positive and negative)
  - Help identify strengths and weaknesses
- Basic financial analysis tools include:
  - Common size financial statements
  - Ratio analysis
  - Trend analysis of common size statements and ratios

# Valuation Approaches

Businesses / assets are typically valued using one of three approaches:

- Income Approach
- Asset / Cost Approach
- Market Approach

# Income Approach

The Income Approach determines value by converting anticipated economic benefits into a present single amount,

$$\text{Value} = \frac{\text{Benefit stream}}{\text{ROI}}$$

where Return on Investment (ROI) is the risk adjusted rate of return an investor requires to justify investment in an asset.

# Asset Approach

**Method used to value a business based on the difference between the fair market value of assets and liabilities.**

- Method is sound for estimating the value of a non-operating business (i.e., holding or investment companies).
- Good method for estimating the value of a business which is continuing to generate losses, or which is to be liquidated.
- Method sets a “floor value” for determining total entity value, because it does not address the operating earnings of the business.

# Market Approach

Theoretical application of the market approach is to allow the analyst to use a group of similar companies to determine relationships that will be applied to the subject company. The similar companies will not be identical to the subject company, but are intended to provide guidance during the valuation process.

- **Comparability traits include:**
  - Same or similar line of business
  - Similar competitive positions within the industry
  - Similar historical rates of growth
  - Similar historical and current levels of profitability
  - Similar capital structures
  - Similar product lines
  - Similar size, relative to sales volume and total assets

# Conclusion of Value

## In arriving at the conclusion:

- Correlate and reconcile the results from the approaches and methods used
- Assess the reliability of the results obtained under the different methods
- Determine whether the conclusion of value should reflect the results of
  - One approach or method or
  - A combination of the results of one or more approaches and methods

# Discounts and Premiums

The final value reached in the valuation may be more or less than the value that was calculated as a result of fundamental discounts and premiums.

- **Some of the common discounts and premiums are:**
  - Control premium
  - Minority discount
  - Discount for lack of marketability

Valuation discounts and premiums are supported by empirical market studies.

# Discounts and Premiums

- Control Premium – An amount or percentage by which the pro-rata value of a controlling interest exceeds the pro-rata value of a non-controlling interest in a business enterprise, to reflect the power of control.
- Minority Interest Discount – A discount for lack of control applicable to an ownership interest of less than 50 percent of the voting interest in a business enterprise.
- Discount for Lack of Marketability – An amount or percentage deducted from the value of an ownership interest to reflect the relative absence of marketability, or the ability to quickly convert property to cash at minimal cost.

# Post-Valuation Subsequent Events

## Two types to consider:

- Events **known or knowable** at the valuation date should be taken into consideration
- Events not known or knowable should not be taken into consideration

## In situations where the valuation is meaningful to the intended user beyond the valuation date

- Post valuation events may be of such a nature and significance as to warrant disclosure (at analyst's option) to keep users from being misled
- Such disclosures are for information only

# Do the Results Make Sense?

## Test the Conclusion

- After you reach your conclusion, do not forget to test it for reasonableness!
- Ask yourself two key questions:
  - **If I were the buyer, would I pay this much for the business?**
  - **If I were the seller, would I sell it for that much?**
- If the answer to either of these questions is “no”, go back to the drawing board and see where you went wrong!

# Intangible Assets

**FASB pronouncements have substantial implications for the valuation of purchased goodwill.**

- Promotes better reflection of economic value of goodwill.
- Provides for better classification of intangibles (amortizable vs. non-amortizable).
- Provides for annual impairment testing.

**Intangible assets recognition criteria:**

- Contractual or legal rights (even if it cannot be separated and/or sold), or
- Capable of being separated or divided and sold, transferred, licensed, rented, or exchanged
  - Regardless of intent
  - Either individually or with a related contract, asset or liability
- Assembled workforce acquired in a business combination should be included in goodwill

# Intangible Examples

- Marketing-related intangible assets (trade names, trademarks, etc)
- Customer-related intangible assets (customer list, backlog, etc)
- Artistic-related intangible assets (photos, books, music, etc)
- Contract-based intangible assets (agreements, licenses, contracts, etc)
- Technology-based intangible assets (patents, software, trade secrets, etc)

# Financial Advisory Practices

## *Can't you just tell me a multiple?*

- Referred to as 'rules of thumb'
- Multiple of gross? EBITDA? Assets under management?
- Rules of thumb miss the details
  - Do all practices have the same product mix?
  - Are all client bases the same age?
  - What is client turnover?
  - What is average account size?
  - Fee income versus commission income?

# Financial Advisory Practices

## Sole Practitioners

- A book of business is not necessarily a business!
- Requires the skills and on-going management of the practitioner
- Transitioning successfully requires that clients accept the 'new' advisor

## Multi-partner / Ensemble Firms

- More 'business-like'
- Value exists in areas other than the 'client list'
- Larger, fee driven practices have more consistent cash flows

# Financial Advisory Practices

## Tips for Transitioning Practices – General Considerations

- Stock vs. asset sales
- Consulting/employment/non-compete agreements
- Buy-sell agreements
- Terms and financing
- Due diligence

# Financial Advisory Practices

## Tips for Transitioning Practices - Sellers

- Get your house in order
- Understand what you are selling
  - Not all 'value' may be transferable
  - How much value is tied to goodwill of practitioner?  
How much can be transferred with careful planning?
- Move as much of your practice to recurring, fee based income as possible

# Financial Advisory Practices

## Tips for Transitioning Practices - Buyers

- Understand what you are buying
  - Are historical revenues inflated by non-recurring front-end loads?
  - What is the length and amount of trailing commissions?
- How much of the client base could you afford to lose in transition?

# Discussion Forum

Participant Questions?

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